Internal Revenue Service

memorandum

CC:TL-N-3875-88
Br2:DCFegan

date: MAR 10 1988

to: District Counsel, [redacted] CC:[redacted]

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

Your request for technical advice dated February 24, 1988, was received and assigned March 2, 1988. As the advice concerns a case on the [redacted], trial calendar, we are giving it expedited consideration.

ISSUE

Whether the assumption of petitioner [redacted]s indebtedness by the [redacted] as part of the exchange for the stock of the [redacted] is taxable as a dividend from the [redacted] 0351.10-00.

CONCLUSION

There is no dividend to the taxpayers on the facts in this case. The issue should be conceded.

FACTS

Prior to [redacted], [redacted] was sole shareholder of [redacted] shares of stock in the [redacted] ([redacted]). In conjunction with the acquisition of this stock, he incurred indebtedness with an outstanding balance as of [redacted], as follows:

[redacted]	$[redacted]
Total	$[redacted]

It appears that payment on the notes was made by the [redacted] and the payments were treated as distributions to [redacted].

On [redacted], Articles of Organization of [redacted] ([redacted]) were filed with the Office of the

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Secretary of the Commonwealth of [redacted]. On [redacted], [redacted] transferred all his stock in the [redacted] in exchange for all the stock in the [redacted] plus the assumption of the three notes above. The notes to the Bank were rewritten and the [redacted] guaranteed the notes to [redacted]. The effect of this transaction was to relieve [redacted] of all liability on the notes while he remained sole shareholder of [redacted] through the [redacted]. The transaction also relieved him of paying tax on subsequent payment of the notes by the [redacted], which would have been a dividend to the extent of earnings and profits.

The petitioners reported $[redacted] in long-term capital gain from this transaction on their [redacted] return, a $[redacted] sales price minus a $[redacted] basis. However, because of a settlement with Appeals for a prior year, petitioners' basis in the stock has been increased to $[redacted].

The Service determined that the transaction did not produce capital gain, but ordinary income in the form of a dividend. Specifically, the Service determined the $[redacted] in liabilities assumed by the [redacted] was a dividend to [redacted] to the extent of [redacted]'s current earnings and profits, $[redacted].

DISCUSSION

The facts of this case are similar to those in Rev. Rul. 80-239, 1980-2 C.B. 103. That ruling concerned a taxpayer who owned all the stock of a corporation (X) with substantial earnings and profits. He transferred that stock to a newly created holding company (Y) in exchange for all its stock plus cash Y borrowed from a bank. The obligation of Y was guaranteed by X and secured by the X stock. Subsequent to the transaction, Y repaid the bank loan with funds it received from X. On these facts, the Service noted section 304(a)(1) of the Code did not apply and concluded the transaction was, in substance, a disguised dividend from X to the taxpayer to the extent provided in section 301.

The concern that prompted the publication of Rev. Rul. 80-239, was that section 304 contained a loophole that gave shareholders an opportunity to circumvent the dividend rules of sections 301 and 316. Applying section 304 meant that dividend equivalence would be made by looking to the earnings and profits of Y. Y, being a newly created corporation, had no earnings and profits, so no dividend equivalence could be found by applying section 304.

Internally, we always knew we would be unlikely to sustain the position of the revenue ruling in litigation. The fact is Y, and not X, borrowed the money and distributed it to the taxpayer. Ordinarily, a party which obtains a loan and which for financial

accounting purposes is regarded as the borrower of indebtedness continues to be viewed as such even though another party acts as a guarantor of the loan. A loan guarantee, without more, cannot cause the guarantor to be equated with the true borrower for federal income tax purposes. Various facts and circumstances, including whether the nominal borrower was thinly capitalized or whether the lender would have made the loan without the guarantee, are also usually considered before a determination is made as to who is the true borrower of indebtedness. Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972), cert. denied, 409 U.S. 1076 (1976); and Rev. Rul. 79-4, 1979-1 C.B. 150. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), 1943 C.B. 1011.

However, in Rev. Rul 80-239, Y was not thinly capitalized; it held the X stock. Thus, in substance, as well as in form, the loan was to Y.

The situation presented in your case is essentially the same as that in Rev. Rul. 80-239. In determining whether there is a dividend, we attach no significance to the fact that the revenue ruling concerns a cash payment to the taxpayer while your case concerns assumption of a preexisting debt of the taxpayer.

The loophole Rev. Rul. 80-239 was designed to temporarily avoid has been closed by statute. Section 304(b)(3)(A), added to the Code by the Tax Equity and Fiscal Responsibility Act of 1982, 1982-2 C.B. 462, and amended by the Tax Reform Act of 1984, 1984-3 C.B. (Vol. 1) 461, provides that section 304, rather than section 351, controls the treatment of property received in a distribution to a related corporation. Amended section 304(b)(2) provides that in determining dividend equivalence, you look to the earnings and profits of first the acquiring corporation and then the issuing corporation.

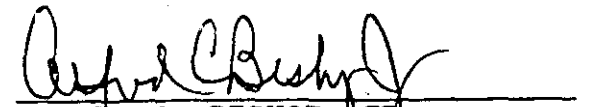
Because Rev. Rul. 80-239 was designed to have in terrorem effect only, the position expressed therein is dubious as applied to pre-TEFRA years, and the issue is controlled by statute for later years, a project is underway to modify or revoke the revenue ruling. For these same reasons, we recommend the position taken in the revenue ruling not be advanced in litigation for the [redacted] tax year.

RECOMMEDATION

We recommend you concede no dividend arose on the facts of your case, but the debt assumption was section 357(c) gain giving

rise to long-term capital gain as contended by the taxpayer. We see no viable alternative arguments that should be made.

MARLENE GROSS

By: 

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